

Consumer Trends in the
Public, Private, and Nonprofit Sector

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1. Introduction

Americans across the country clearly need help. In December 2009, the Financial Industry Regulatory Authority (FINRA) Investor Education Foundation in consultation with the Treasury Department completed the first National Financial Capability Study in the United States. It found that:

- Nearly half of survey respondents reported facing difficulties in covering monthly expenses and paying bills.
- The majority of consumers do not have “rainy day” funds set aside for anticipated financial emergencies and similarly do not plan for predictable life events, such as their children’s college education or their own retirement.
- More than one in five Americans reported engaging in high-cost, alternative borrowing methods, such as payday loans and pawn shops.
- While many consumers believed they were adept at dealing with day-to-day financial matters, they nevertheless engaged in financial behaviors that generated expenses and fees and exhibited a marked inability to do basic interest calculations and other math-orientated tasks.
- Few consumers compared the terms of financial products or shopped around before making financial decisions (FINRA Foundation, 2009).

When put alongside the economic difficulties many families in the United States are currently facing, the results highlight how important it is for financial education leaders to search for more effective strategies. Better financial education outcomes are not, however, achieved in a vacuum. The broader context in which financial education is promoted, and the broader context in which it is received, matter enormously to the success of our efforts moving forward.

In our view, the context for financial education efforts in the years ahead includes: (1) broader economic and financial trends, which have worked, and are likely to continue to work, against the wealth accumulation efforts of low- and middle-income Americans, (2) the coming financial services overhaul legislation, which holds the potential to lead to better financial outcomes for millions of Americans, (3) the lack of evidence of the effectiveness of many financial education programs, which could, if not corrected, reduce the resources spent on financial education, and (4) the behavioral economics field, which is already having a significant impact on government, employer, and nonprofit efforts to promote saving and financial education nationwide.

1.1 Economic and Financial Trends: Deregulation, Product Innovation, and Consumer Choice

If financial literacy is “knowing what you need to know to make reasonable financial decisions,” the nation faces a financial literacy crisis. What creates the crisis is not a sudden decline in financial knowledge, but the rapid expansion of what consumers need to know. Consumers have become far more responsible over the past few decades for their own financial well-being.

The need for sophistication in choosing self-beneficial financial products was greatly enhanced by the financial deregulation that started in the United States in the 1970s. This process included the deregulation of brokerage commissions on May 1, 1975, as well as the deregulation of standardized bank interest rates (Regulation Q) in the early 1980s. During this period, state usury laws were eliminated or superseded by federal statute (as in the case of South Dakota), greatly enhancing the profitability of credit cards and other types of consumer debt. In addition, the relaxation of interest rate ceilings on consumer loans opened up the subprime market for

consumer debt, first in unsecured debt such as credit cards, then in shorter-term secured debt such as auto paper, and finally in longer-term secured debt such as home mortgages and lines of credit. Financial innovations, such as adjustable rate loans, teaser rate loans, and Alt A (low-documentation) loans, grew on the asset side of financial intermediaries—and facilitated equal and opposite innovation on the liabilities side with debt that was securitized with these relatively new and imperfectly understood consumer loans.

Retirement planning is another area of increasingly sophisticated financial decision making for consumers. Over the last several decades, Social Security and employer pensions have been the dominant sources of retirement income for the bulk of the U.S. elderly population, and they provided a reasonably adequate income. But Social Security already replaces a significantly smaller share of household pre-retirement earnings than it did when first implemented—and will replace even less going forward, due to the rise of dual-earning couples, the program's Full Retirement Age, the taxation of benefits, and likely cuts in benefits to shore up the program's finances. The dramatic shift in employer plans—from traditional defined benefit pensions to defined contribution plans, such as 401(k) plans—essentially marks the withdrawal of employers from the retirement income system. Employers at one time had managed both the accumulation and decumulation of retirement savings, using sophisticated financial advisors and bearing substantial risk. With the shift to defined contribution plans, individual households must manage these costly and risky processes themselves.

Individual households bear increased financial responsibility in other areas as well. College costs have risen dramatically over the past few decades and state governments—long the primary funders of higher education—have shifted an increasing share of the burden to students and parents. Health, long-term care, and disability insurance also have become far more critical

and treacherous, financial decisions that households must manage. What makes these responsibilities especially difficult to manage is that they generally must be addressed simultaneously. Should new workers first pay down their student loans, save for a down payment for a house, or contribute to a 401(k)? Should mid-career workers fund their own 401(k), purchase life or disability insurance, or pay some or all of their children's tuition? Should new retirees buy long-term care insurance, hold on to their savings as a precautionary asset, or draw an income out of their savings—and if so, how?

Successfully managing these complex financial decisions requires a good deal of skill. Study after study has shown that individuals know little about financial concepts and products—and what they know is often wrong. Study after study in behavioral economics has also shown that myopia, a lack of self-control, and a host of cognitive and emotional impediments stand in the way of effective financial decision making. Overcoming the financial literacy deficit must necessarily involve overcoming these behavioral impediments as well.

Clearly, financial innovation offers benefits as well as possible confusion to consumers. A vast array of competitive products offers the opportunity of consumer choice, which could lower costs and better meet the cash-flow requirements of consumers who were sophisticated enough to understand their own needs and evaluate the various product offerings. Unfortunately, the complexity of many of these new products, often combined with a lack of transparency, expose unsophisticated consumers who were unwilling or unable to afford the services of experts to the likelihood of making very expensive mistakes.

1.2 Broader Economic Trends

Recent reports from a range of academics, think tanks, and others argue that the current economic slump—now known as the Great Recession—is likely to continue for several years for

many reasons. These include: the “de-leveraging” of households following the bursting of the housing asset bubble a few years ago; the “jobless recovery”; and the negative effects of longer-term, structural changes in the U.S. economy over the last generation.

To understand the implications of this economic moment for the future of financial education, however, we must first describe how we arrived at this balance-sheet–led recession (as opposed to a business-cycle recession).

The next Great Depression—if it comes to that—will have been caused by a consumer-driven economy that eventually exhausted its ability to borrow. American consumption makes up a stunning 71 percent of the U.S. economy (Bureau of Economic Analysis, 2010). We largely financed that consumption through debt. For example, household debt as a percentage of disposable income rose from 90 percent in the 1990s to 133 percent in 2007. At the same time, the Federal Reserve’s Household Debt Service Ratio (DSR), which measures the ratio of all debt payments to disposable income, increased dramatically, reaching a record level of almost 14 percent in 2007. Households, and the economy, simply could not absorb any more debt. Consumption slowed, adjustable rate mortgages kicked-in, people starting defaulting on their home and consumer loans, banks got nervous about the underlying value of their assets, credit got tight, making spending and investment even harder, which further suppressed consumption—and so on until we found ourselves in the sluggish economy we are now in.

This necessary de-leveraging—or debt reduction—itself poses a set of challenges, as a quick look at some measures of household assets reveal. Federal Reserve (2009) data show while all but the lowest quintiles saw a rise in median net worth between 2004 and 2007, we ended 2007 with about one-third of households with net worth less than \$10,000 and about one in six having zero or negative net worth. While equity markets have rebounded to some extent over the

last couple of years, housing prices have not—and in fact may decline yet another 10 percent. According to the Federal Reserve (2010), some \$6 trillion in homeowner's equity was lost between 2006 and 2009. Not surprisingly, this housing crash has hit low- and middle-income homeowners the hardest, for they own few financial assets outside of their homes. And while the household savings rate increased in 2009, reaching 6.4 percent in May, it has since declined to just above 3 percent. Lower savings means a longer period of de-leveraging and thus a longer period of sluggish growth and adjustment.

Compounding the challenges of de-leveraging is the fact that the underlying fundamentals of the economy are not strong. As reported by the Economic Growth program of the New America Foundation (2010), while GDP has grown at annualized rates ranging from 2.2 to 5.6 percent in the last three quarters, it has been a jobless recovery—and the worst jobless recovery since 2001. Even though the economy added 83,000 private-sector jobs in June 2010, unemployment hovers near double digits and a 14.6 million jobs deficit persists. Corporate profits have rebounded, but wage growth remains stagnant, growing only 1.6 percent from April 2009 to April 2010. In fact, as reported by William Emmons (2010) of the Federal Reserve Bank of St. Louis, who looks at a broad range of economic inputs and outputs, the current recession and rebalancing of the economy is the culminate of uneven economic growth since 1997–1998, which was accelerated by the bursting of the asset bubble starting in 2007.

Even more fundamentally, Emmons and others believe that we can expect a prolonged slump as we look for a new basis for economic growth—a profound challenge acknowledged by President Obama when he called for Americans to move away from a “borrow and spend” to a “save and invest” economy during an April 14, 2009, speech at Georgetown University. Whether we become a save-and-invest economy, China and India begin to consume more, or the “green

economy” or public investment in infrastructure and education become the new basis for economic growth, we do not yet know. Nor is it out of the question that *nothing* replaces the American consumer as the engine of economic growth, leading to declining living standards in the United States and around the world.

In other words, most Americans cannot count on broad-based or steady economic growth in the years ahead to protect or grow their financial holdings. And, given the grim fiscal picture of the United States, Americans are not likely to count on expanded safety nets either—with expanded health-care coverage for many a notable exception—now or later in life. For example, the Economic Policy Institute (2009) and others report that for more than a quarter of American households, income from Social Security, pensions, and personal savings are expected to replace less than half of the pre-retirement income.

These data and trends mean, among other things, that Americans will increasingly need to rely on their own savings and investments to advance economically, achieve a secure retirement, invest in their children’s education, and pass on wealth and opportunities to the next generation. And, because this is a balance-sheet–led recession, Americans must reduce their debts and rebuild their savings to bolster the larger economy. A McKinsey Global Institute (2006) report on the coming “global wealth shortfall,” for example, pointed out that within the next 20 years, historically high-saving, aging societies in Asia and elsewhere will begin to reduce their saving to support their own consumption and retirements, forcing the United States to generate its own saving (as early as possible, the report recommends). These challenges require financial education efforts to be both more urgent and more focused in the years and perhaps decades ahead.

How Congress and financial educators actually get more Americans to save more money remains a challenge, but a few proposals are under consideration by Congress. First is an expansion of the Savers Credit, currently a non-refundable tax credit to encourage retirement savings for low-income households. The expanded credit would make it refundable and extend its benefits to include moderate-income taxpayers (specifically, those with AGI of up to \$65,000 per year for married households). Second would be the creation of “Auto IRAs,” which—building on behavioral economics (discussed later) and the success of opt-out 401(k) plans—would set up opt-out automatic payroll contributions into IRAs for workers not currently participating in employer-sponsored retirement plans such as 401(k)s. And third are proposals to create and seed savings accounts automatically at birth for all newborns with funds earmarked for post-secondary education, home purchase, and retirement. Naturally, we must consider the possible effects of the soon-to-be-enacted financial services overhaul bill on efforts by Americans to reduce their debts, or at least to manage less-toxic or more “suitable” debt.

However, enactment and implementation of new saving proposals are not likely to occur anytime soon due to the recession and the current political climate of fiscal restraint, posing deeper challenges to financial educators, U.S. households, and the health of the U.S. economy.

2. Financial Reform Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act is poised to have significant effects on financial education efforts going forward through overall reforms to the financial system and through the creation of a new consumer protection agency. First, the broad purpose of the legislation—to reform and strengthen the financial system—in itself is designed to lead to less financial risk for average consumers. Provisions addressing—albeit unevenly and, in the view of some, inadequately—systemic risks, credit rating agencies, derivatives, capital

requirements, mortgage and foreclosure reforms, monetary policy, investor protections, the structure of the banking regulators (Federal Reserve, OCC, and FDIC), and other elements of our financial sector are poised to enable consumers to conduct financial transactions in a more stable environment. The intent of these reforms is to make it possible for consumers and financial educators to evaluate specific financial products without separately having to assess the broader stability of the financial system providing those products. (Imagine, for example, if certain “toxic” sub-prime mortgages had been better regulated or disallowed because of the systemic risks they posed the financial sector?)

Whether or not the overhaul achieves that ambition, however, is a matter of intense debate. Treasury Secretary Timothy Geithner remarked, “We’re on the verge of legislating sweeping reforms of our financial system, to fix what was broken in our system, recognizing that those failures in the United States were very consequential to the world as a whole.”

Challenging that view are many. Economist and writer Joseph Stiglitz recently wrote, “If the strongest provisions of each are preserved, there is the prospect of hallmark regulatory reform—marking the end of an era of mindless deregulation. But if the final bill that emerges from conference reflects the lowest common denominator, then we can only pray to be spared another financial crisis in the near future.” Richard S. Carnell, an assistant Treasury secretary in the Clinton administration, remarked, “This bill is on track to being the most misguided piece of federal banking regulation in the past half-century.” And *New York Times* columnist Joe Nocera wrote, “Will the bill that emerges from this conference do what it is intended to do? Will it prevent another crisis? Will it put an end to government bailouts? The painful answer is: probably not.”

The second way consumers and financial educators are poised to benefit from the new legislation are the consumer protections envisioned in the Federal Reserve–embedded Consumer Financial Protection Bureau (CFPB) as well as from the specific provisions within the legislation addressing financial education. According to the Senate Banking Committee, “The new independent Consumer Financial Protection Bureau will have the sole job of protecting American consumers from unfair, deceptive and abusive financial products and practices and will ensure people get the clear information they need on loans and other financial products from credit card companies, mortgage brokers, banks and others.” For example, a single independent agency—the CFPB—will for the first time have the ability to write, examine, and enforce regulations for consumer protections for all financial institutions offering consumer financial services or products.

How and whether this is actually achieved remains to be seen, but should CFPB succeed at realizing its ambitious vision, it could be a huge win for consumers and financial educators alike. For example, some proponents of this effort believe that although Congress declined to mandate “plain vanilla” or “default” financial products in the financial services overhaul bills, the net result will be more incentives for companies to offer fewer exotic, complex products and more traditional and transparent products—that by curbing a broad range of abusive financial practices, financial institutions are more likely to engage in more conservative lending and other, safer financial practices.

Turning to the specific financial education provisions of the legislation, the CFPB will have the following responsibilities and duties:

- The CFPB director would become vice chairman of the Financial Literacy and Education Commission (FLEC), a multi-agency task force that coordinates

financial literacy efforts across the government and is nominally housed at the Treasury Department.

- The CFPB director would establish an Office of Financial Literacy that will be “responsible for developing and implementing initiatives intended to educate and empower consumers to make better informed financial decisions.” The office also would “develop and implement a strategy to improve the financial literacy of consumers that includes measurable goals and objectives,” consistent with the National Strategy for Financial Literacy, including providing opportunities for consumers to access:
 - a. Financial counseling
 - b. Information to assist with the evaluation of credit products, and the understanding of credit histories and scores
 - c. Savings, borrowing, and other services found at mainstream institutions
 - d. Information for handling educational expenses
 - e. Assistance in developing long-term savings strategies
 - f. Assistance during tax preparation to help consumer claim Earned Income Tax credits (EITC) and federal benefits.
- The CFPB director would establish an Office of Financial Protection for Older Americans that will be responsible for activities to facilitate the financial literacy of individuals 62 years and older on protection from unfair and deceptive practices and on current and future financial choices.

The legislation would further require both the U.S. Government Accountability Office (GAO) and the U.S. Securities and Exchange Commission (SEC) to study and

evaluate the effectiveness of financial literacy programs among consumers and investors, respectively.

While many observations could be made, an important one is the implied acknowledgment in the legislation that we can no longer rely solely on more disclosures or more information to change financial behavior and improve financial outcomes for American consumers. Among other changes, the CFPB makes a move toward structured one-on-one, human interaction in financial decision making, and attempts to achieve that in light of recent research and best practices in the financial education field. More broadly, the creation of the CFPB may be a seminal, defining moment in the financial education field, and, again, should its ambitions be realized, it would be an enormous boost to the wealth accumulation and financial know-how efforts of millions of Americans.

However, as with the broader financial sector reforms goals of the legislation, some observers doubt whether the CFPB will realize its ambitions. First, no funding is specified for financial education efforts in the bill. And some believe that the proposed agency started out strong (as articulated in the Treasury's June 2009 White Paper), but has been so weakened since that it might not be worth it. Harvard Law Professor Elizabeth Warren, who first articulated the idea of a standalone consumer protection agency and now heads a Troubled Asset Relief Program (TARP) oversight panel created by Congress, remarked, "I think it still has what it needs to succeed, but it's right at the edge."

3. Evaluating the Effectiveness of Financial Education

A significant and growing body of research has documented the fact that many Americans make expensive "mistakes" in their personal financial decisions (Campbell, 2006). The research also tends to show that the majority of these mistakes is made by those with the

fewest financial resources, thereby further exacerbating inequalities in standards of living (Lusardi & Mitchell, Mandell, 2009a).

While financial education would appear to be the logical antidote to these mistakes, successful implementation of such programs has been elusive. Jump\$tart surveys have found that semester-long high school classes have not shown a lasting effect on financial literacy (Mandell) and college classes have fared little better (Mandell, 2009a). Most financial education programs in the workplace tend to be voluntarily attended by those employees who need it least (Mandell, 2008). Some promise has been seen when dealing with younger, pre-high school students (Mandell, 2009c) and when using highly interactive, real-time programs in high school, such as a stock-market game (Mandell, 2009a). Experiments also suggest the effectiveness of financial education at the point of sale (Lusardi, Keller, & Keller, 2009) and when used as a hurdle with those who are highly motivated to achieve an imminent goal (Statin). From a cost-benefit perspective, however, traditional methods of financial education have yet to prove their value.

This has not, however, discouraged the flow of funding into the field—generally in support of curricula that duplicate others that have yet to prove their effectiveness. Nor does it seem to affect public officials who are more likely than ever to mandate courses in the area of personal finance (NASB, 2006)—without consideration of the lack of qualified teachers in a very technical area (Loibl, 2008). Everyone, it seems, wants the problems caused by financial illiteracy to go away, with little or no cost to the taxpayer and without the imposition of costly and onerous regulations protecting consumers from their own fallibilities. Under the likely scenario that financial innovation will be allowed to continue, we must ask about the type of financial education that is likely to help consumers (and future consumers) avoid costly mistakes in their choice of financial products.

First, let us address the question of *when* such education is likely to be most effective. To help frame the question, let us consider educating consumers about the choice between a fixed rate and a variable rate mortgage, surely an area in which many of the most expensive mistakes were made during the recent financial crisis.

If we wished to educate consumers while we still had some control of what they studied, this education would have to occur while they were still in high school, ideally right before graduation, to make the education most relevant. However, since few 18-year-olds will be making home mortgage decisions for at least 10 years, and since the fast pace of financial innovation tends to make many products in this category obsolete during that time span, we must question both the motivation of students to learn and retain these materials and the likely usefulness of such knowledge.

Even apart from the issues of motivation and shelf life, making a decision between fixed and floating rate mortgages is very complex, presupposing a solid working knowledge of yield curves, LIBOR rates, monetary policy, underwriting standards, and even option theory. A few courses in consumer economics will not equip a teacher to be able to handle this subject. Nor will a textbook, which is outdated well before it is printed. What exactly can you teach high school students about this subject that will equip them to make reasonable decisions when the time comes?

This example can be extended to most other areas in which consumers have been making their most costly mistakes, including choice and use of student loans, unsecured and secured short- and intermediate-term credit, home purchase, and investment asset choice and allocation. It is difficult to postulate exactly what should be taught to a primary or secondary (or even tertiary) school student that would be helpful to them—and who would be capable of teaching it.

Once you leave the area of mandatory (K–12) education, you start to look at voluntary education, in college or for adults. When it comes to adult education, we see a serious election bias—those who probably are most in need of such education (those with less formal education, lower incomes, and less financial experience) are also least likely to want to extend their educations in this manner (Mandell, 2008). Most likely to show up at employer seminars on investing, retiring, or even consumer credit are the “fine tuners” who (1) enjoy classes and (2) tend to keep up with and enjoy dealing with financial issues.

When it comes to financial education, perhaps it isn't knowledge that we wish to change as much as it is behavior. We would like consumers (and future consumers) to save more, borrow less, and carefully research important financial decisions—in short, to defer immediate gratification. In the famous “marshmallow” study by Walter Mischel and his colleagues (Mischel, Shoda, & Rodriguez) we learn that small children who are capable of deferring immediate gratification—resisting the immediate consumption of a pre-lunch marshmallow in exchange for two—become far more successful adults than those who yield to immediate temptation. “Deferrers” tend to save more for the future, invest more in their own human capital as well as in financial capital, and borrow less for non-capital items. They tend to employ, in David Laibson's terms, a lower discount rate for future returns, both positive and negative (Laibson, 1997).

The question we must answer is whether the deferral of immediate gratification is innate or learned and, if learned, how easily and at what age. There is some evidence that gratification deferral can be changed. From 1990 to 2004, the savings rate in the demographically homogeneous Japan fell from about 15 percent to 3 percent, a much greater percentage fall than occurred in the United States during the same period (Katayama, 2006).

If we assume that “desirable” behaviors can be learned, we must ask next how and at what age. Many desirable behaviors are instilled by parents through operant conditioning at an age before children are capable of relevant cognition. Children are toilet “trained,” not educated. Likewise, children are trained to brush their teeth well before they understand the impact of bacteria on tooth decay. It is likely that attitudes toward thrift (gratification deferral) are formed partially during these early years as part of a family’s culture. For example, a family might include a prohibition against finishing off all the milk at night and not leaving enough for breakfast the next morning. This would suggest that our focus should turn from the “financial literacy” education of high school students to behavior modification of children in kindergarten and early grades. This is supported by the work of child development experts who focus on the early development of financial behavior.

“There is no such thing as a purely financial behavior. Actions such as saving or spending have important emotional components. There are also strong social norms governing financial behaviors. Moreover, financial behaviors may be simply habitual; routines or practices that people have adopted without explicit justification. The basic socio-cultural perspective on development is that young children will initially participate in practices without really understanding their bases” (Holden, Kalish, Scheinholtz, & Novak 2009).

Decades ago, school-based savings accounts were used to help develop early savings behavior, but have become almost extinct due to a variety of factors, including privacy laws, state laws allowing parents full access to their children’s accounts, mistrust of school employees, and bank functional cost analysis that showed (at one time) school-based accounts to be unprofitable.

Research over the past 15 years has yielded some positive outcomes from school-based financial education. Student scores on the Jump\$Start national exam were boosted by about 2 percent as the result of having trained teachers teaching *required* semester-long courses in personal finance (Mandell, 2006). Students who have played a stock market game in class tended to score about 3 percentage points higher than others (Mandell, 2009a). There also has been a lagged but positive effect of classes in personal finance on behavior reported by Bernheim, Garrett, and Maki (2001), Mandell (2009b), and others, sometimes occurring decades after completion of the education. While it is too early to give up totally on school-based financial education, the difficulties inherent in successful implementation must cause us to look to alternative solutions to major consumer financial mistakes.

4. Behavioral Economics: The New Paradigm

The emergence of behavioral economics, which blends economics with psychology, is the fourth and final larger force or broader context outlined in this paper for considering the future of financial education. Few ideas have revolutionized the savings and financial education fields more than behavioral economics. Stated most simply, behavioral economists believe that the most effective way to change how individuals behave is to alter the framing of their choices. Working from the theory that individuals are predictably irrational, the aim is to “nudge” people to act a certain way or to install “choice architectures” that make it easier for individuals to arrive at a desired or “rational” choice.

To better understand how behavioral economics has influenced the financial education field—and how it is poised to shape that field in the years ahead—it is important to understand some of its basic ideas and lessons thus far. The key principles of behavioral economics (especially as it applies to financial decision making) include simplicity, choice constraints,

“automaticity,” mental accounting, and the creation of social norms. For those working in the asset building and personal finance fields, the eight most relevant lessons from behavioral economics over the last several years have been summarized by Amy Brown (2008) as follows:

1. The power of defaults. A default is the choice we make when we do not choose. And because people are often lazy, prone to procrastinating, confused, or just reluctant to make decisions, the default option often becomes the most common choice.
2. Loss aversion. Losses loom larger than gains in people’s minds. In other words, we feel worse about losing \$20 than we feel happy about finding \$20. As a result, we tend to skew our choices to those that minimize the possibility of loss.
3. Proliferation of choices. We tend to think that more choices are always better. But in fact, when faced with too many alternatives, people can become overwhelmed or confused and often are less likely to choose any of the options.
4. Hassle factors. We are remarkably sensitive to hassles, even seemingly minor ones like walking an extra block or signing another form. Each additional hassle can make us less likely to do something—even something we want to do.
5. Channel factors. As opposed to hassles, the right channels—such as a partially completed form or a map that shows us where to go—can point us in a certain direction. And once we have taken a first step, we are more likely to keep going.
6. Mental accounting. People compartmentalize money into distinct categories and have different propensities to save or spend from different mental accounts.

7. Identity. People think about themselves in a variety of different ways—as a parent, worker, poor person, woman, etc.—and they often make different choices in the same situation when they have different “identities” in mind.
8. Following the crowd. People often feel more comfortable making a choice—and are therefore more likely to make that choice—when they know that others (especially others with whom they identify and respect) have made the same one.

The most well-known success stories for behavioral economics—and, more specifically defaults—come from defined contribution plans or 401(k)s. Defined contribution plans offer many economic incentives for employees to save for retirement, such as tax-deferral on contributions and earnings and, in many instances, an employer matching contribution. However, plan data suggest that, despite these incentives, many employees choose not to enroll in employer plans and risk entering retirement with inadequate savings. Research identified behavioral impediments to plan use (such as procrastination) as well as a lack of financial knowledge in the working population (Mitchell & Utkus, 2004). To overcome these barriers, some 401(k) sponsors began implementing automatic enrollment for new employees, which resulted in large increases in participation—from roughly one-third of employees to levels sometimes in excess of 90 percent (examples include Choi et al., 2004; Swanson & Farnen, 2008; Beshears et al., 2008). Drawing on early successes, Congress introduced incentives for employers to adopt automatic enrollment through the Pension Protection Act of 2006 (PPA). Between 2004 and 2009, the percentage of plans with automatic enrollment increased from 1 to 16 percent (GAO, 2009).

Another success story is the “Save More Tomorrow” pilot, in which employees agreed in advance to commit a portion of a future pay raise to retirement savings. The architects of the “Save More tomorrow” pilot found that:

- 78 percent of those eligible to participate in the plan elected to use it
- 98 percent who joined the plan stayed in it long enough to receive two pay raises
- 80 percent remained in through a third pay raise

In addition, over a period of 28 months, the average saving rates for individuals participating in the pilot rose from 3.5 percent to 11.6 percent over the course of 28 months. These results suggest that behavioral economics can play an important role in designing effective savings programs (Thaler & Benartzi, 2003). And, in fact, similar commitment devices have proven effective in getting low-income households to save (Karlan, 2010).

Although the expansion of automatic enrollment in employer-sponsored defined contribution plans will likely improve participation among those covered by such plans, many issues remain to be addressed to help *all* Americans save for retirement. Roughly 40 percent of workers are not eligible to participate in a defined-contribution plan because their employers do not offer one (GAO, 2009). Minorities, young workers, and low-income workers are disproportionately less likely to work for an employer with a pension plan, limiting access to retirement savings options for these potentially vulnerable populations. Policymakers currently are considering a plan grounded in behavioral economics to expand coverage of retirement savings plans. Implementation of “automatic IRAs” would require employers that do not offer a retirement savings plan and have more than 10 employees to transfer a default rate of 3 percent of their pay through payroll deductions to an IRA (Treasury, 2010). Employees who choose not to participate would be given the right to opt, while those opting in would be able to change their

contribution percentage. Eligible employees who make contributions to automatic IRAs would also receive a match through a proposed expansion of the saver's credit (Treasury, 2010).

The trend toward using behavioral economics theories to expand retirement savings raises a number of important research questions that remain to be addressed. For example, at least with respect to automatic IRAs, it is not clear what the optimal default contribution rate should be. Some experts note that a 3 percent contribution rate may not produce sufficient retirement wealth (Nessmith et al., 2007) and that defaults can actually produce lower contribution rates for those who might have actively enrolled (Choi et al., 2006). This, in turn, introduces consideration of automatic escalation of contribution rates, which have been studied to some extent in the context of defined contribution plans (Beshears et al., 2008).

Additional issues include whether opt-out levels for automatic IRAs will be similar to those seen in automatic 401(k)s—and the extent to which default contribution rates can be increased before the opt out increases. If the automatic IRA population has higher job turnover, how will participants handle their account balances when they leave jobs? Also, does automatic enrollment increase an individual's or household's aggregate savings? Or does it merely offset savings? This question is particularly pertinent when considering the impact of this policy on the vulnerable groups that will be covered by automatic IRAs if pay deductions lead to high interest credit use or other activities designed to preserve pre-auto enrollment levels of consumption.

Finally, while automatic IRAs might deal with one issue directly related to racial/ethnic disparities in retirement savings by providing more workers with access to plans, research suggests that even when minorities are covered by a retirement savings plan, disparities in program use remain. This is true even when automatic enrollment is available. A recent study by Ariel/Hewitt on racial disparities in 401(k) plans shows that, even after controlling for earnings

and tenure, African American and Hispanic plan participants have lower plan participation and savings rates (Ariel/Hewitt, 2009). And a study conducted by the U.S. Office of Personnel and Management found similar disparities in Thrift Savings Plan use among federal workers (OPM, 2010). Although automatic enrollment narrows the gap in participation rates between African American and white employees, significant racial disparities remain (Madrian & Shea, 2001). It will be helpful if researchers aim to better understand the factors that specifically influence participation and plan use of minorities so that decision makers can develop better interventions.

At least two major critiques, however, must be aired. On the one hand, behavioral economics—referred to by some, including its strongest proponents, as “libertarian paternalism”—might go too far. On the other hand, one can argue that it does not go far enough.

First, there is the potential for the paternalism implied in behavioral economics—which posits a rather grim view of human nature, such that we are in need of a paternalist—will go too far. The fear is that too many choices will be made by one’s employer or one’s government at too high a cost to free choice and to the responsibilities associated with those choices. Thaler and Sunstein (2003) recognize the tension between “libertarianism and paternalism” and, indeed, believe that the automatic 401(k) is a sound and defensible application of libertarian paternalism since, while a “good” wealth-building choice is made for you, you always have the option of getting out of it.

But, in fairness, other experts challenge whether opt-out provisions in fact achieve the right balance. As Alan Wolfe (2009) remarked, “People’s capacity to lead lives of their own choosing would be undermined, because decisions they believed to be their own would actually be the products of behind-the-scenes manipulation. And those who create the architecture

responsible for that manipulation, because unelected and uncountable, would have considerably more power than those being manipulated.”

While some believe that behavioral economics goes too far, others believe it needs to go further, at least in the area of personal finance. Harsh critics of financial education efforts to date—those who note that we have learned little about the effectiveness of financial education—point to the impressive results from the retirement savings experiments described previously and in other tests of behavioral economics in personal finance (see Bertrand, Mullainathan, & Shafir, 2004, 2006; Brown, 2009; Thaler & Sunstein, 2008). These advocates suggest that behavioral economics can and should be more prominent—possibly serving as the new paradigm for personal finance.

In fact, the enthusiasm for behavioral economics has prompted some to say that it is *not* a substitute for financial education (Lopez-Fernandini, 2010). Along this vein, although automatic enrollment will deal with some of the behavioral/knowledge issues that inhibit retirement savings plan participation, providing Americans with effective tools to make good use of these plans still will be critical. Data abound suggesting that Americans have low financial literacy, are not well informed about the public and private pensions they have, and often fail to develop retirement plans (Helman et al., 2007; FINRA, 2009). It will be important to assess whether well-designed and well-timed information treatments coupled with default enrollment features can improve financial capability in a way that standalone information treatments cannot.

What, then, are the implications of behavioral economics for the future of financial education? As stated earlier, we believe behavioral economics is one of the major forces impacting financial education—but how is it being impacted, and is it as overwhelmingly positive as many experts suggest? We think it is fair to say that financial education efforts alone

would not have achieved the same dramatic increase in 401(k) participation rates described previously. But does that mean the successes of behavioral economics approaches to savings are unqualified? While a full assessment is well beyond the scope of this paper, we are comfortable acknowledging both the pros and the cons of behavioral economics, as well as the challenges and opportunities for financial education leaders, practitioners, and policymakers stemming from the rapid rise of this field.

On the positive side, the financial education field in general appears to be moving in the direction of achieving not just changes in knowledge and intentions, but changes in behavior. Many, in fact, prefer the notion of “financial capability” over financial education because the former implies positive financial behavior change as well as knowledge and intentions. So, in this sense, the field of behavioral economics adds a powerful conceptual framework in which to achieve better financial education outcomes going forward.

Another positive influence, especially in this era of tight budgets and eroding public finances, is that behavioral economics offers a way to potentially and significantly improve financial outcomes by making relatively small and inexpensive program and policy changes. For example, when the Pension Protection Act of 1996 was enacted, enabling more companies to offer automatic features in defined contribution plans, Congress did not need to appropriate funding to ensure implementation. Nor did most employers have to incur significant new costs to implement it. Yet this relatively small change is estimated to generate billions of dollars of new retirement savings every year, according to estimates by the Retirement Security Project of the Brookings Institution.

In summary, Americans face many challenges in becoming more financially capable. Policy and products are changing to try to meet these challenges. So while a potentially imperfect solution, behavioral economics has a prominent role to play.

Conclusions and Implications

Over the past decade, policymakers increasingly have seen that financial education can play a critical role in both empowering consumers with the knowledge to make wise decisions when choosing among myriad financial products and as a key pillar to financial market stability. This is clearly borne out in the new financial reform legislation. As financial products and markets become more sophisticated and consumers assume a growing share of the responsibility and risk for financial decisions, we believe that financial education can have profound implications on the financial security, well-being, and prosperity of all consumers. However, the evidence of the efficacy of financial education is still quite thin. Consistent with the financial education tenets of the financial reform legislation, we need to encourage the research and development of “programs that effectively improve financial education outcomes and empower consumers to make better informed financial decisions” (HR 4173, 2010). During a period of diminishing economic resources, it is especially important to carefully evaluate the costs and benefits of any social initiative, including financial education programs. One solution to this problem is the development of data resources to facilitate research into the effectiveness of financial education programs. Data that can do a better job of capturing changes in behavior, are linked to administrative sources, and can be used to track program performance will improve the quality of the evidence base and thereby improve financial programs.

We also believe that financial education leaders need to embrace the field of behavioral economics and end their sometimes quixotic debate with it. While behavioral economics should

never be seen as a substitute for financial education, it is a compatible strategy with statistically significant evidence of effectiveness. Thus, behavioral economics and financial education used together can be powerful tools to achieve better financial outcomes going forward.

And in an era of tight budgets and eroding public finances, behavioral economics offers a way to potentially and significantly improve financial outcomes by making relatively small and inexpensive program and policy changes. The leadership of the financial education field, with years of experience behind it, is well positioned to challenge, inform, and ultimately shape the behavioral economics field in helping millions of Americans build wealth and financial security for themselves and their children.

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